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STRATEGIES

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The Benefits of Telling the Ugly Truth

YOUR stock portfolio has been climbing like a rocket, and you're beginning to think that your financial adviser is a genius.

Then he tells you he's not. "It was just luck," he says.

That oil stock, the one that jumped 80 percent? A good pick, sure — but he had no idea it was *that* good. "It was a surprise," he says, "Don't count on it happening again."

Disappointing? Maybe. But it sounds like the truth, and that may mean that the rest of what he says is true, too. This kind of self-deprecation may not be standard patter for financial advisers, but Shlomo Benartzi, a behavioral economist at the University of California, Los Angeles, says it should be.

In order to build trust and credibility, Professor Benartzi suggests, advisers should come right out with the truth, especially when it's ugly. If advisers have been merely lucky — or have made recommendations that were outright failures — they should come clean about it, he says. Such admissions may be off-putting initially, he said in an interview, but as long as they are followed by a clear description of what an adviser is doing well — assuming, of course, that *something* is being done well — candor is good business.

"From a behavioral standpoint, it's really better for your credibility if you're honest," Professor Benartzi said. If you don't take credit when the market rises, for example, you may not have to take responsibility when it goes down.

In a new study for Allianz Global Investors, a unit of Allianz, the financial giant, he draws on the broad findings of behavioral economics to make some startling recommendations for advisers. The paper — which assumes that most advisers are honest and won't use their newly acquired psychological acumen to exploit clients — is titled "Behavioral Finance in Action: Psychological Challenges in the Financial Adviser/Client Relationship and Strategies to Solve Them."



JOHN NELSON

Candor from financial advisers builds trust with clients, Shlomo Benartzi says.

Behavioral economics holds that individuals do not necessarily act rationally and in their own self-interest. Instead, they make intuitive decisions that may be swayed by phenomena like "framing." Far more people are likely to buy a package of cold cuts, for example, if it's framed, or labeled, as "90 percent fat-free" than if it's labeled "containing 10 percent fat."

The paper opens what it calls the "behavioral finance toolbox" for advisers, explaining how to overcome obstacles posed by investors' "intuitive minds."

For example, research by Professor Benartzi and Richard H. Thaler, an economics professor at the University of Chicago — and a regular contributor to Sunday Business — found that people

were generally likely to save more if asked to "precommit" to doing so in the future. Their findings have been incorporated in many 401(k) plans.

By agreeing to deduct a certain amount of money from your paycheck starting next Jan. 1 and to increase the deduction every New Year's Day thereafter, you can procrastinate — you don't have to do anything now — yet increase your savings substantially. And if those increases coincide with raises, your take-home pay won't decline, avoiding "the mind's hypersensitivity to loss," the paper says.

You can also opt out freely — which may make you more comfortable with the plan in the first place.

The new paper takes precommitment strategies much further, advocating, for example, a "Ulysses contract" — or a "commitment memorandum" that spells out what to do when the markets move 25 percent up or down. The adviser and the investor are both supposed to sign it — agreeing in advance, perhaps, to buy *more* stocks in a market plunge, and not to sell. Conversely, when markets soar, they may be committed to selling overvalued stocks, not buying more of them — rebalancing the portfolio to restore an agreed-upon asset mix.

The concept of resisting temptation this way is at least as old Homer. In "The Odyssey," Ulysses had his crew bind him to the mast and agree in advance to ignore his entreaties before sailing near the Sirens, whose songs were irresistible. It worked for Ulysses. Whether contemporary investors are ready for the strategy is another question.

"The idea is great, but it may be a little aggressive for many people," said Bud Pernoll, senior managing director of Bay Mutual Financial, an independent financial advisory firm in Santa Monica, Calif. Many individuals and some companies will balk at signing a "contract" that might seem to limit their flexibility, he said, even though the strategy makes a lot of sense.

Mr. Pernoll is a fan of behavioral finance and its concepts, but he says the field is in its infancy and is just beginning to be absorbed by financial practitioners.

The Ulysses contract is deliberately provocative, Professor Benartzi said. It “forces you to think in advance — both adviser and client — and put a plan in writing and explain, when you’re tempted to take an action, how it fits into your plan.” He added that “the flip side — controlling the intuitive mind” so it doesn’t do damage — is important, too.

The paper gives advisers tips for enhancing their credibility. They should display their credentials prominently on the wall — this makes their recommenda-

tions more believable, the paper says. And they should present the downside of an investment strategy before explaining its benefits. “By talking about the downside first,” the paper says, “the financial adviser is displaying honesty that elicits a greater willingness in the listener.”

IN the wrong hands, of course, such insights could be quite dangerous, said Barbara Roper, director of investor protection for the Consumer Federation of America. Behavioral economics can teach an adviser bent on enriching himself how to more skillfully push an investor’s buttons.

Advisers have many different backgrounds and credentials, and work under

different ethical guidelines: no universal fiduciary standard requires all advisers to put investors’ interests first. That could change: as required by the Dodd-Frank Act, the Securities and Exchange Commission has studied the issue and recommended the creation of such a universal standard. But it has not taken final action.

Cathy Smith, co-director of the Allianz Global Investors Center for Behavioral Finance, says the company hasn’t taken a position on the issue. Professor Benartzi, on the other hand, says he favors “having more consistency in the credentials” of financial advisers as well as “a requirement that they should first and foremost do what’s right for the client.”

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